No. 14084

In the United States Court of Appeals for the Ninth Circuit

OREGON-WASHINGTON PLYWOOD COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ON PETITION FOR REVIEW OF THE DECISION OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR THE RESPONDENT

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OPINION BELOW

The findings of fact and opinion of the Tax Court (R. 12-24) are reported at 21 T.C. No. 115.

JURISDICTION

This petition for review (R. 42-46) involves excess profits taxes for the calendar year 1944. The notice of deficiency was mailed to the taxpayer on December 27, 1951. (R. 4.) Within the prescribed ninety-day period, on March 19, 1952, the taxpayer filed a petition for redetermination with the Tax Court under the provisions of Section 272 of the Internal Revenue Code. (R. 8.) The decision of the Tax Court sustaining the

Commissioner's deficiency determination was entered on July 21, 1953. (R. 24-25.) The case is brought to this Court by a petition for review filed by the taxpayer on September 18, 1953 (R. 42-46). Jurisdiction is conferred on this Court by Section 1141(a) of the Internal Revenue Code as amended by Section 36 of the Act of June 25, 1948.

QUESTION PRESENTED

Whether the Tax Court erred in holding under the facts that the taxpayer did not have during the years 1944 and 1945 an "outstanding indebtedness" which was "evidenced by" a "note" or "mortgage" within the meaning of Section 719(a)(1) of the Internal Revenue Code?

STATUTE AND REGULATIONS INVOLVED

Internal Revenue Code:

SEC. 719 [as added by Sec. 201, Second Revenue Act of 1940, c. 757, 54 Stat. 974]. BORROWED INVESTED CAPITAL.

(a) *Borrowed Capital.*—The borrowed capital for any day of any taxable year shall be determined as of the beginning of such day and shall be the sum of the following:

(1) [as amended by Sec. 230(b)(2) of the Revenue Act of 1942, c. 619, 56 Stat. 798] The amount of the outstanding indebtedness (not including interest) of the taxpayer which is evidenced by a bond, note, bill of exchange, debenture, certificate of indebtedness, mortgage, or deed of trust, plus,

* * * * *

(b) *Borrowed Invested Capital.*—The borrowed invested capital for any day of any taxable year

shall be determined as of the beginning of such day and shall be an amount equal to 50 per centum of the borrowed capital for such day.

(26 U.S.C. 1946 ed., Sec. 719.)

Treasury Regulations 112 promulgated under the Internal Revenue Code:

SEC. 35.719-1 *Borrowed Invested Capital.*—The borrowed invested capital for any day of the taxable year is 50 per cent of the borrowed capital for such day determined as of the beginning of such day. Borrowed capital is defined to mean:

(a) Outstanding indebtedness (other than interest, but including indebtedness assumed or to which the taxpayer's property is subject) of the taxpayer which is evidenced by a bond, a promissory note, bill of exchange, debenture, certificate of indebtedness, mortgage, or deed of trust, plus

* * * * *

STATEMENT

The facts as found by the Tax Court are as follows:

The taxpayer is an Oregon corporation which, during the years material herein, was qualified to transact business in the State of Washington, as a foreign corporation. The taxpayer's income and excess profits tax returns for the taxable years 1944 and 1945 were filed with the Collector of Internal Revenue for the District of Washington. (R. 13.)

At all times material to this proceeding the taxpayer owned and operated a plywood manufacturing plant at Tacoma, Washington, and in that vicinity there was a scarcity of raw material, namely, peeler logs. (R. 14.)

On July 30, 1941, T. A. Peterman acquired title by

deed to approximately 3,500 acres of timberland in Tillamook County, Oregon, which he had not conveyed or encumbered prior to the execution of a contract of purchase and sale dated August 30, 1943, hereinafter mentioned. That tract of timberland was cruised in December, 1940, and January, 1941, and the timber cruiser's report showed an estimated total of 109,528,000 feet of merchantable timber. The tract contained a large amount of dead timber which had been killed by a forest fire and the time for using the dead timber as peeler logs was limited. During 1943 and until November 16, 1944, T. A. Peterman, Katherine Peterman and Gladys Peterman were partners doing business under the firm name of Peterman Manufacturing Company which owned a large amount of logging equipment and maintained a logging organization in the area of the above-mentioned tract of timberland. The taxpayer had no logging equipment or facilities for logging timber. (R. 14.)

On August 30, 1943, T. A. Peterman and his wife as owners and the taxpayer as purchaser executed a contract of purchase and sale of the above-mentioned 3,500-acre tract of timberland in Tillamook County, Oregon. The agreed purchase price was $500,000 payable $25,000 on date of the contract, $75,000 on or before September 30, 1943, and the balance of $400,000 "evidenced by a note made payable" to Peterman Manufacturing Company and delivered thereto on or before September 30, 1943. (R. 14-15.) Payments on the note, plus accrued interest at the rate of three per cent per annum on deferred balances, were due on the 15th day of each month beginning November 15, 1943, on the basis of $5 per thousand feet, commercial log scale, cut and removed by the purchaser during the previous

month. If the purchaser defaulted in the monthly payments logging operations were to cease until the default was made good. The purchaser agreed, *inter alia,* that it would conduct its operations on the lands in a good and workmanlike manner in accordance with the best methods and usages practiced in the Douglas Fir area and the Oregon laws and regulations; that it would pay all taxes and assessments levied upon the lands; that it would scale the logs cut and removed and keep accurate records; and that no loss or destruction of, nor injury or damage to any part or all of the property from fire, wind, or other element or casualty whatsoever would give ground for the termination or rescission of the contract or relieve the purchaser of its obligations thereunder. The contract further provided that "time is of the essence of this contract and each and every portion thereof" and that in the case of purchaser's default in payments or performance of other terms of the contract and after certain notice, the owners may elect to declare the contract at an end with all payments and improvements on the property forfeited as liquidated damages, or the owners may elect to declare all unpaid sums plus accrued interest immediately due and payable and bring suit therefor. (R. 15-16.) Further, the owners reserved title to the lands and timber thereon until complete performance of the contract by the purchaser but title to the logs passed to the purchaser as they were cut and removed from the land. Upon completion of the purchaser's obligations under the contract the owners agreed to execute and deliver a deed to the timberlands in fee simple with covenants of warranty and good commercial abstract or title insurance in a sum equal to the price paid for the land subject to

certain existing record reservations and easements. (R. 16.)

The taxpayer made the cash payments totaling $100,-000 required by the contract of August 30, 1943, and on September 30, 1943, delivered the following note as provided in that contract (R. 16-17):

Tacoma, Washington, September 30, 1943.

$400,000.00

As provided in an agreement dated August 30, 1943, the undersigned for value received promises to pay to the order of the Peterman Manufacturing Company the sum of Four Hundred Thousand Dollars ($400,000.00) in lawful money of the United States of America. Payments on this note plus accrued interest at the rate of 3% per annum on deferred balances shall be made on the 15th day of each month beginning November 15, 1943.

The basis of such principal payments to be $5.00 per thousand feet commercial log scale for all logs except wood logs cut and removed by purchaser or its agents during the previous calendar month as provided in the agreement between T. A. Peterman and Ida C. Peterman, owners, and Oregon-Washington Plywood Company, purchaser, dated August 30, 1943, covering certain timberlands in Tillamook County, Oregon.

Oregon-Washington Plywood Company,
By (S.) Philip Garland,
Vice President.

Attest:
(S.) Mathilda M. Barrett,
Secretary.

On September 18, 1943, the Peterman Manufacturing Company executed a written agreement with the taxpayer whereby for certain agreed prices to be paid by the taxpayer, the former agreed, *inter alia,* to furnish all equipment and labor and pay all costs for logging all merchantable timber on the above-mentioned 3,500-acre tract for the taxpayer. The Peterman Manufacturing Company further agreed to log an annual average of from twenty to twenty-five million feet a year until all of the timber be logged from the tract, to commence shipping logs in October and to be in full production by February, 1944. (R. 17.)

On September 30, 1943, the Peterman Manufacturing Company executed an additional agreement with the taxpayer to purchase at certain prices all logs cut other than the fir peeler logs and certain fir sawmill logs needed by the taxpayer. (R. 17-18.)

T. A. Peterman died on November 16, 1944. Thereafter the surviving partners, the decedent's wife and executors of the decedent's estate, desired to be relieved of the agreements mentioned in the next two preceding paragraphs as to logging operations and the purchase of logs, and they were terminated by a cancellation agreement dated January 4, 1946, between the interested parties and the taxpayer. Also on January 4, 1946, the same interested parties and the taxpayer executed an amendment to the above-mentioned contract dated August 30, 1943, whereby, *inter alia,* the balance of the purchase price of the timberland of approximately $241,000 owing by the taxpayer under the August 30, 1943, contract and September 30, 1943, note, would be paid as follows: a minimum payment of $5,000 on June 1, 1946, and the first of every succeeding

month thereafter until the principal of the note was paid in full, plus additional payments "to be credited on the aforesaid note and contract" at the rate of $5 per thousand feet cut in excess of seven million feet during 1946 and twelve million feet during any subsequent calendar year. Furthermore, the interest provided for in the August 30, 1943, contract and note thereunder was expressly waived and it was agreed that no interest would be charged or collected "on the balance owing on the aforesaid indebtedness or on said note." (R. 18-19.) Except as so amended the August 30, 1943, contract remained in full force and effect. (R. 19.)

On January 4, 1946, the taxpayer entered into a contract with the firm of Yunker and Wiecks for the cutting of timber on the abovementioned 3,500-acre tract. (R. 19.)

The taxpayer's records show that 90,933,000 feet of timber were logged from the land between August 30, 1943, and August 31, 1952. The taxpayer's above-mentioned note for $400,000 dated September 30, 1943, was paid in full sometime prior to December 22, 1949, on which date the taxpayer acquired legal title to the 3,500-acre tract of timberland by warranty deed from the heirs of T. A. Peterman. (R. 19.)

The Commissioner determined an excess profits tax deficiency of $19,925.35 against the taxpayer for the calendar year 1944 and was sustained by the Tax Court in its decision that, in determining the excess profits credit based upon the invested capital method the taxpayer's obligation for the balance due under a contract for purchase and sale of timberlands and an alleged promissory note pursuant to that contract, did not constitute an outstanding indebtedness evidenced by a note

or mortgage which may be included in borrowed capital for the years 1944 and 1945; within the meaning of Section 719(a)(1) of the Internal Revenue Code. (R. 12-13, 24-25.) Accordingly this appeal resulted.

SUMMARY OF ARGUMENT

This appeal presents the single question whether a land contract of conditional sale and a so-called note executed by taxpayer created an indebtedness evidenced by a note or mortgage resulting in borrowed invested capital within the meaning of Section 719(a)(1) of the Internal Revenue Code. The statute requires both that there be an indebtedness and that it be evidenced by one of the kinds of indebtedness enumerated in the statute. Here there was neither.

There was no indebtedness because the taxpayer's obligation to pay the alleged amount of the contract price was conditioned on the cutting of enough plywood logs to pay the price at the rate of $5 per thousand feet of timber cut and removed by the taxpayer or its agents. Both the conditional land contract and the alleged note contain the same language regarding the rate of payment and the latter instrument even makes specific reference to the contract. If the words of the statute are interpreted in their *ordinary everyday sense,* it is clear that there was neither a mortgage, nor a note involved herein. The contract was not a mortgage since the vendor retained title—thus making the contract a conditional sales agreement, an instrument not included within Section 719(a)(1). The so-called note does not satisfy the statute and Regulations since it is not negotiable and the promise to pay is not unconditional.

Even assuming *arguendo* that the requirements of

Section 719(a)(1) have been satisfied, it is still impossible to compute the borrowed invested capital within the meaning of Section 719(b) since there is no evidence as to the quantity of timber actually cut at any time during the taxable years.

ARGUMENT

The Two Instruments Herein Involved Did Not Create an Indebtedness Includible in Taxpayer's Borrowed Capital Under Code Section 719

The issue in this case is simply whether the taxpayer had, during the years 1944 and 1945, an "outstanding indebtedness" which was evidenced by a note or mortgage within the meaning of Section 719(a)(1) of the Internal Revenue Code, *supra.* It is our position that the Tax Court correctly held that the taxpayer's obligation during the years 1944 and 1945 under the two instruments involved herein was not an outstanding indebtedness evidenced by a note or mortgage within the meaning of Section 719 of the Code.

In computing excess profits tax liability imposed by the Internal Revenue Code (Section 711) [1] a corporation is allowed an "excess profits credit" which may be determined in either of two ways: (1) under the "income" method (Code Section 713), or (2) the "invested capital" method (Section 714). The credit allowed under the latter method is based on the "average invested capital" for the taxable year (Section 715),

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[1] Section 201 of the Second Revenue Act of 1940, c. 757, 54 Stat. 974, added to the Internal Revenue Code subchapter E of Chapter 2 (Sec. 710 *et seq.*), known as the Excess Profits Tax Act of 1940. The tax was repealed by Section 122(a) of the Revenue Act of 1945, c. 453, 59 Stat. 556, effective for taxable years beginning after December 31, 1945.

including "borrowed invested capital" as defined in Section 719, *supra.*[2]

Taxpayer used the invested capital method in computing its excess profits tax credit, and in its excess profits tax returns for 1944 and 1945,[3] it included in "borrowed capital" unpaid balances in the amounts of $171,974.05 for 1944 and $130,746.55 for 1945—that is, fifty per cent of its average daily balance under its contract for purchase and sale of timberlands. (R. 26.) The Commissioner disallowed the inclusion of these amounts and was sustained by the Tax Court.

Section 719(a)(1) defines "borrowed capital" as the "amount of the outstanding indebtedness * * * which is evidenced by a bond, note, bill of exchange, debenture, certificate of indebtedness, mortgage or deed of trust." The statute thus imposes two separate requirements: (1) that there be an outstanding indebtedness, (2) that the indebtedness be evidenced by one of the specified types of instruments. *Canister Co.* v. *Commissioner,* 164 F. 2d 579 (C.A. 3d), certiorari denied, 333 U.S. 874. The taxpayer cannot demonstrate borrowed capital because it was not indebted, but if it were indebted the conditional sales contract which evidenced the indebtedness is not one of the types of indebtedness described in the statute nor does the alleged

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[2] The invested capital credit is determined under Section 714 by applying certain rates to the amount of the "average invested capital" for the taxable year, the statutory invested capital being, in effect, the total of the paid in capital of the corporation and retained earnings, plus an amount equal to fifty per cent of the "borrowed capital" for the taxable year. Secs. 715-720 of the Code.

[3] Since the excess profits tax credit for 1945 exceeded excess profits tax net income for that same year, there was no deficiency for 1945.

note qualify as a true promissory note as required by the statute and Regulations. For these reasons the decision below is correct.

A. *The conditional sales contract and the alleged note did not create an indebtedness within the meaning of Section 719(a)(1)*

To constitute "outstanding indebtedness" as that term is used in Section 719(a)(1) the taxpayer's liability to pay must be unconditional. *Bernard Realty Co.* v. *United States,* 188 F. 2d 861, 863 (C.A. 7th); *Downey Co.* v. *Commissioner,* 172 F. 2d 810 (C.A. 8th); *Consolidated Goldacres Co.* v. *Commissioner,* 165 F. 2d 542 (C.A. 10th), certiorari denied, 334 U.S. 820; *Frankel & Smith Beauty Dept.* v. *Commissioner,* 167 F. 2d 94 (C.A. 2d); *Canister Co.* v. *Commissioner, supra; Gilman* v. *Commissioner,* 53 F. 2d 47 (C.A. 8th).

We think it is not open to question that the promise to pay contained both in the conditional sales contract and the alleged note was itself conditional. Both provide that the $400,000 balance was to be paid at the rate of $5 per thousand feet commercial log scale, for all logs except wood logs cut and removed by the taxpayer or its agents during the previous calendar month. (R. 15, 17, 31 and 39.) In the event of default, the seller was given the option of declaring the contract at an end and taking as forfeit all payments heretofore received, considering them liquidated damages, or of declaring all unpaid sums plus interest immediately due and payable. It is apparent from these provisions that the taxpayer did not unconditionally obligate itself to pay $400,000. It is true that, if it had defaulted and the seller had elected the second option, the $400,000 would

have become an indebtedness, but default and the proper subsequent election were contingencies which did not occur by the end of the years here involved and accordingly no indebtedness arose.

In *Frankel & Smith Beauty Dept.* v. *Commissioner, supra,* the taxpayer agreed to pay for certain equipment installed in its store by its landlord, the payments to be made over a period of years, at the expiration of which time it was to become the owner of the property. The agreement contained a provision giving the landlord-vendor the right to terminate the contract, in which event the taxpayer was not required to make further payments. In holding that the amounts payable under the contract were not includible in taxpayer's borrowed capital, the court stated (p. 96):

> In the second place, the obligation, in several respects, was not unconditional. We need point to but one condition: Jordan Marsh had the right to terminate the agreement at will, on sixty days' notice at any one of divers dates during the ten-year period of the lease; if it so acted, then, by the provisions of the contract, taxpayer was not required to make any further payments * * *.

Whether taxpayer would default any of its obligations under the contract and, if so, whether the vendor would exercise its option to terminate the contract and relieve taxpayer of the obligation to make further payments, is beside the issue. The important consideration is that the parties saw fit to make such provision in their agreement, and that during the taxable years such contingency existed.

That "an obligation is not necessarily an 'indebtedness' " is clear. *Deputy* v. *du Pont,* 308 U.S. 488, 497.

Here the taxpayer undertook many obligations, such as the conducting of its operations in a good and workmanlike manner; complying with all laws and regulations relating to safety appliances and equipment, fire supervision, patrol and equipment, and slash disposal; paying taxes and assessments; maintaining accurate records; and saving harmless the sellers from any claims arising out of taxpayer's operations. (R. 32-33.) But the obligation of the taxpayer did not ripen into an indebtedness until each log was cut. *Consolidated Goldacres Co.* v. *Commissioner, supra; Downey Co.* v. *Commissioner, supra; Wm. A. Higgins & Co.* v. *Commissioner,* 4 T. C. 1033, 1043. The indebtedness so created was not required to be paid until the 15th of the month next succeeding. (R. 31.) It is therefore clear that no debtor-creditor relationship existed for the contract price and no indebtedness resulted prior to the beginning of logging operations. Accordingly, taxpayer is not entitled merely on account of either of the two instruments to include any amount as borrowed invested capital in computing its excess profits taxes for the years 1944 and 1945.

B. *The contract was not a "mortgage" within the meaning of Section 719(a)(1)*

Even granting *arguendo* that the contract was an unconditional indebtedness, taxpayer still cannot prevail because it has failed to meet the additional statutory requirement that the indebtedness be "evidenced by a bond, note, bill of exchange, debenture, certificate of indebtedness, mortgage, or deed of trust." The Tax Court held that this requirement was not satisfied, holding that the contract herein involved was a conditional land contract. (R. 22.)

In defining borrowed capital for federal tax purposes as "indebtedness * * * evidenced by a * * * note * * * mortgage," Congress used the terms "mortgage" and "note" according to their ordinary legal meanings, and not according to any particular state law interpretation, as taxpayer erroneously contends.[4] (Br. 15-17.) *Bernard Realty Co. v. United States, supra,* p. 864; *Consolidated Goldacres Co.* v. *Commissioner, supra,* pp. 545-546. See also *Crane* v. *Commissioner,* 331 U.S. 1; *Estate of Putnam* v. *Commissioner,* 324 U.S. 393; *United States* v. *Pelzer,* 312 U.S. 399; *Lyeth* v. *Hoey,* 305 U.S. 188. Had Congress intended to include in the definition any indebtedness evidenced by an instrument which is equivalent to a mortgage or note it could readily and simply have said so. Instead, it narrowly defined the type of indebtedness includible in borrowed capital by specifying that it must be evidenced by a "bond," "note," "mortgage," etc. By specifically enumerating the kinds of instruments which qualify as evidences of indebtedness it excluded all other forms of indebtedness. To hold otherwise would render superfluous the clause "evidenced by a bond, * * *."

This is made abundantly clear by Section 719(a)(1). The report of the Subcommittee of the Committee on Ways and Means on Proposed Excess-Profits Taxation and Special Amortization, 76th Cong., 3d Sess., originally recommended that (p. 5):

> to the equity invested capital so arrived at there be added, under a graduated limitation at varying percentages (100, 66⅔, 33⅓), the borrowed capital

[4] As the Tax Court observed (R. 22-23), even though the land contract may be the equivalent of a mortgage for certain remedial purposes under the laws of Oregon, that fact is not controlling here.

of the taxpayer *which is evidenced by a written promise to pay.* (Italics ours.)

And H. Rep. No. 2894, 76th Cong., 3d Sess. (1940-2 Cum. Bull. 496, 514), which accompanied H. R. 10413, the Second Revenue Bill of 1940, shows (p. 26) that borrowed invested capital was defined as the outstanding indebtedness evidenced by the various instruments mentioned in the Code as it now is, plus the phrase "or any other written evidence of indebtedness." Significantly, neither the Committee on Finance of the Senate in its report (S. Rep. No. 2114, 76th Cong., 3d Sess., p. 14 (1940-2 Cum. Bull. 528, 539)), nor the Committee of Conference in its report (H. Conference Rep. No. 3002, 76th Cong., 3d Sess., p. 12 (1940-2 Cum. Bull. 548, 555)), included the phrase "or any other written evidence of indebtedness" in its definition of borrowed capital. And Section 719(a)(1) of the Code, as added by the Second Revenue Act of 1940 finally enacted, also omits the additional phrase. This history of a legislative narrowing of the scope of indebtedness confirms the conclusion necessitated by the statutory language itself, namely, that Congress intended to confine the definition of borrowed capital to the specific types of instruments enumerated. The Tax Court has consistently so held. *Journal Publishing Co.* v. *Commissioner,* 3 T.C. 518; *Wm. A. Higgins & Co.* v. *Commissioner, supra,* p. 1043; *Flint Nortown Theatre Co.* v. *Commissioner* 4 T.C. 536; see also *Economy Savings & Loan Co.* v. *Commissioner,* 5 T.C. 543, affirmed in part and reversed in part on other grounds, 158 F. 2d 472 (C.A. 6th).

This conclusion is further reinforced by the well-established proposition that a claimed credit, privilege,

or exemption from tax cannot be granted unless specifically authorized by Congress and the claimant must bring himself squarely within the terms of the authorizing statute. *Helvering* v. *Northwest Steel Mills,* 311 U.S. 46, 49; *Deputy* v. *duPont, supra,* p. 493; *New Colonial Co.* v. *Helvering,* 292 U.S. 435, 440.

The interpretation of the statute sought by the taxpayer was flatly repudiated in both *Bernard Realty, supra,* and *Consolidated Goldacres, supra.* There, as here, the taxpayer contended that a contract to purchase property, title to be held by the vendor until the last installment of the purchase price was paid, created an indebtedness which was in substance a "mortgage" within the meaning of Section 719(a)(1). The court in *Consolidated Goldacres* stated (pp. 545-546):

> Words used in a federal taxing statute must of course have a uniform meaning, and are therefore not to be construed according to state law unless the Congress has shown an intention to do so. * * *
> As we have seen, the Congress has deliberately chosen words to define the type of "outstanding indebtedness" which will be included in the excess profits credit, and those words should be given their ordinary meaning in common usage. It is true, as pointed out by Consolidated, that in terms of liability imposed, there may be little, if any, distinction or difference between the legal relationship created by a mortgage and a conditional sales contract. Both instruments are intended to provide a measure of security for the performance of an incurred obligation, but they are not used synonymously or interchangeably to describe or define the legal relationship created thereby. Courts have generally recognized the legal differ-

> ence between the two. * * * Especially where, as here, it becomes necessary to discern the legislative intention.

Any reliance by taxpayer on *Brewster Shirt Corp.* v. *Commissioner,* 159 F. 2d 227 (C.A. 2d) is plainly misplaced. In the *Brewster* case the taxpayer assigned accounts receivable to a factor as security for a loan, and under the factoring agreement the taxpayer became unconditionally indebted to the lender. Moreover, the factoring agreement constituted a "mortgage," which fell squarely within the embrace of the statute. The *Brewster* case was distinguished in the *Consolidated Goldacres* case (p. 546) on these grounds, which also serve to distinguish it from this case. That the Second Circuit Court of Appeals in the *Brewster* case was following the same principles as were applied in the *Consolidated Goldacres* and *Canister* cases is apparent from the same court's decisions in *Frankel & Smith Beauty Dept.* v. *Commissioner, supra,* and *In re Lake's Laundry,* 79 F. 2d 326, certiorari denied, 296 U.S. 622. Moreover, the court in the *Brewster* case carefully distinguished the situation there from those in *Journal Publishing Co.* v. *Commissioner, supra; Wm. A. Higgins & Co.* v. *Commissioner, supra;* and *Flint Nortown Theatre Co.* v. *Commissioner, supra,* in all of which the Tax Court held that borrowed capital in the Section 719 sense had not been demonstrated.

In any event, even if (contrary to the decisions) the term "mortgage" as used in Section 719 could properly be construed as embracing an instrument which is "equivalent" to a mortgage, there is no basis for the taxpayer's contention that the instant contract was in

substance a mortgage. It was a conditional land contract, both in substance and in form.

As was fully pointed out in *Bernard* and *Consolidated Goldacres,* Congress used the term "mortgage" in Section 719 in its ordinary sense, and intended it to apply uniformly to all taxpayers subject to the federal excess profits tax. And it is abundantly clear that the term "mortgage" in its common everyday sense has a well accepted meaning throughout the nation which is to be sharply distinguished from the term "conditional sale." 3 Jones, Chattel Mortgages and Conditional Sales 38-39; 2A Uniform Laws Annotated, Bogert's Commentaries on Conditional Sales, P. 11; *In re Halferty,* 136 F. 2d 640 (C.A. 7th); *In re Burgemeister Brewing Co.,* 84 F. 2d 388 (C.A. 7th); *In re Lake's Laundry, supra; Bailey* v. *Baker Ice Machine Co.,* 239 U.S. 268, 271; *Harkness* v. *Russell,* 118 U.S. 663; *Wm. W. Bierce, L'd* v. *Hutchins,* 205 U.S. 340, 348.

The distinction between the two devices is that a mortgage imposes a lien upon property to which the mortgagor has legal title whereas the contract of conditional sale denotes only a change of possession from seller to buyer. 3 Jones, Chattel Mortgages and Conditional Sales 38. That a contract of conditional sale is also used as a security device and that in some few jurisdictions no distinction between a mortgage and contract of conditional sale is made is irrelevant here, since the standard provided by Congress is the term "mortgage" and not all instruments having security elements. The two terms describe distinct devices and, notwithstanding their similarities or dissimilarities, when one is described by name, the other could not have been included in view of the well-established distinction between them. *Consolidated Goldacres Co.* v. *Commis-*

sioner, supra. In *In re Lake's Laundry, supra,* the question was whether property sold under a contract of conditional sale was included in the term "mortgaged property" under subsection (C)(10) of Section 77B of the Bankruptcy Act. The court held that it was not. It stated (p. 328):

> But even though section 77B is a remedial statute to be construed liberally, we think Congress did not intend to ignore the distinction between property mortgaged by a debtor and property held by a debtor as conditional vendee. The distinction has been recognized in legislation from early times, and was a part of the common law. * * * That property held by a conditional vendee is the property of the conditional vendor until the contract price is paid is a principle firmly rooted in the law. *Bailey* v. *Baker Ice Machine Co.,* 239 U.S. 268, * * *.

The above decision was followed by the Seventh Circuit in *In re Burgemeister Brewing Co., supra.* The only difference is that here we have a provision of the Internal Revenue Code that is to be strictly construed, so that *a fortiori* the term "mortgage" cannot be said to encompass a contract of conditional sale.

The agreement here under scrutiny unquestionably constituted a conditional sale, not a mortgage. It expressly provided (R. 35) that title was to be retained by the vendor until full performance by the purchaser. This is "distinctively a feature of a conditional sale." 3 Jones, Chattel Mortgages and Conditional Sales 38-39. The Supreme Court has consistently held that retention of title by a vendor under a contract of sale stamps the arrangement as a conditional sale. *Harkness* v. *Russell, supra; Wm. W. Bierce, L'd* v. *Hutchins,*

supra; Bryant v. *Swofford,* 214 U.S. 279. Section 719 (a) (1) does not provide for the inclusion of conditional sales contracts within borrowed capital as defined by the Code for excess profits tax purposes.

C. *The second instrument does not qualify as a "note" within the meaning of Section 719(a)(1)*

We believe that the two instruments created no indebtedness, but if they did, the indebtedness was nevertheless not borrowed capital because not "evidenced by a * * * note, * * * mortgage, * * *." Section 719(a)(1) Internal Revenue Code. We have shown, *supra,* that there was no mortgage. Furthermore, the so-called note (R. 39-40) fails to meet the requirements of the statute as the Tax Court properly held (R. 23-24).

A promissory note, as required by Section 35.719-1(a) of Treasury Regulations 112, has been defined as "a written promise to pay a certain sum of money at a future time unconditionally." *Consolidated Goldacres Co.* v. *Commissioner, supra,* p. 544. See also Black's Law Dictionary (1933 ed.) and Bouvier's Law Dictionary (1914 ed.). The term "note" in commercial, as well as common, parlance means a negotiable note [5] (*American Nat. Bank* v. *Marshall,* 122 Kans. 793, 253 Pac. 214; *Road Imp. Dist. No. 4* v. *Southern Trust Co.,* 152 Ark. 422, 239 S.W. 8), but the instrument here, although labelled a note by the taxpayer, lacks several of the characteristics of such an instrument. Secs. 1-4,

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[5] Taxpayer's contention that the so-called note was payable in a reasonable time may be entitled to some weight in determining when an action may be brought on the instrument or when the statute of limitations begins to run, but the reading of "reasonable time" into the instrument will not serve to make it negotiable.

Uniform Negotiable Instruments Act.[6] By its own terms, the instrument provided that the taxpayer "promises to pay to the order of" (R. 16) the payee $400,000, but in the next paragraph there was the proviso that (R. 17)—

> The basis of such principal payments [was] to be $5.00 per thousand commercial log scale for all logs except wood logs cut and removed by purchaser or its agents during the previous calendar month as provided in the agreement between T. A. Peterman and Ida C. Peterman, owners, and Oregon-Washington Plywood Company, purchaser, dated August 30, 1943, covering certain timber lands in Tillamook County, Oregon.

Since the taxpayer was under an obligation to pay a certain sum of money in monthly installments, equal to and *contingent* upon the quantity of timber cut, it is impossible to find an *unconditional* promise to pay a sum certain on demand or at a fixed or determinable future time. As pointed out by the Tax Court, the language providing for monthly payments on the basis of the quantity of timber cut and removed by the taxpayer renders the instrument conditional, and further prevents the amounts of the installments from being fixed. (R. 23-24.) Neither is the date of final payment fixed or determinable since there is no requirement under

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[6] Section 1 of the Uniform Negotiable Instruments Act provides that an instrument to be negotiable must be—

(1) In writing signed by maker or bearer.
(2) An unconditional promise or order to pay a sum certain.
(3) Payable on demand or at a determined fixed time.
(4) Payable to order or to bearer.
(5) Drawee where addressed must be named or otherwise indicated with reasonable certainty.

the two instruments that any particular quantity of timber be cut in a given month.

A case directly in point is that of *Consolidated Goldacres Co.* v. *Commissioner, supra,* wherein the taxpayer contracted to purchase property and pay for it in installments measured by the amount of ore milled at its plant, title to remain in the vendor until the last installment was paid. To insure payment of the price, the contract obligated taxpayer to operate its plant at maximum capacity. The taxpayer included in its borrowed capital the unpaid balance of the purchase price, claiming that its contractual obligation to pay was tantamount to an unconditional indebtedness evidenced by a note. In affirming the Tax Court's exclusion of the item, the court stated (p. 545):

> Since, as pointed out by the Tax Court, the Congress did not define the term "note", we must conclude that it was intended to be used according to its ordinary legal acceptation. *Crane* v. *Commissioner,* 331 U.S. 1, 6, 67 S. Ct. 1047; *Old Colony R. Co.* v. *Commissioner,* 284 U.S. 552, 560, 52 S. Ct. 211, 76 L. Ed. 484. A close analysis of the instruments convinces us that *there was no unconditional promise to pay* a certain sum of money at some future time. Consolidated's obligation under the contract was to pay a certain sum of money in monthly installments, equal to and contingent upon the amount of ore milled at the plant. The plant was to be operated at capacity, and failure to do so would constitute a breach, entitling Western to declare a default, for which it was granted optional remedies. In the event of default, and after the exhaustion of the remedies, Consolidated was liable for any unpaid balance of the purchase price, but

the *obligation thus imposed was not unconditional* and unilateral. (Italics supplied.)

In this case the Tax Court also pointed out that by its terms, the so-called note must be read with its interrelated contract. Under the contract, a breach of the terms by the taxpayer gave the seller the option to declare the contract terminated and all payments forfeited as liquidated damages, or, declare the unpaid sums plus interest due and payable. The taxpayer was obligated to pay the balance of the purchase price but the obligation was not *unconditional* for at any time a breach of the terms and the seller's election to terminate the contract would have relieved the taxpayer of any further liability. From all of the foregoing, it is clear that the second instrument herein involved lacks certain of the necessary elements of a commercial, negotiable note, thus preventing the instrument from qualifying as an evidence of indebtedness as defined by Section 719(a) of the Code and Section 35.719-1 of Treasury Regulations 112.

D. *Taxpayer's failure to sustain burden of proof*

Assuming for the purposes of the argument that the conditional land contract and the so-called note met all the requirements of Section 719(a)(1), it would nevertheless be impossible to compute the borrowed invested capital within the meaning of Section 719(b), because the taxpayer's indebtedness on any particular day would depend upon the total amount of timber cut up to that time. There is no evidence in this case as to the amount of timber cut at any time during the two taxable years. Since taxpayer has failed to sustain its burden of proof, it cannot prevail.

CONCLUSION

The decision of the Tax Court is correct and should be affirmed.

Respectfully submitted,

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